

Looking for Logic Series

When Merc = Mercantilism

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Blurb: *This first of a three-part series documents how the Euro has staged the largest devaluation in history, and helped European industry reap a rich harvest.*

There is many a woman who has lost her fortune, if not her reputation, by betting that the Euro would be a strong currency, and whose value “should” be around 1.25 US dollars. I myself had made what seemed like a safe prediction last November when I stated that parity with the dollar should be achieved by mid-June 2001. That date has come and gone, but the euro keeps lumbering at its lows.

What has been relatively unnoticed is the magnitude of the depreciation and that it does not follow any known fundamentals. Consider the following – at its introduction (Jan. 1999) the Euro was at 1.18; eighteen months later, it was at 95 cents; and today it is at 0.92; and it reached a trough almost 10 percent lower. Depreciation since introduction is a lofty 30 percent.

Given that inflation in Euroland and its trading partners is identical (actually Euroland has lower inflation) this is a thirty percent *real* depreciation. This is not some third world country we are talking about, nor some tin-pot dictatorship, nor some hyper-inflating economy, but *Europe*, an economy close in size to the US. Can such a large devaluation be possible? Yes, especially with managed currencies, as we saw with the East Asian currencies in 1997, the Mexican peso in 1994, and the British pound in September 1992. But the euro behaving so cheap? It cannot be, in these days of market determined currency rates.

And if it did happen, how come no one noticed? Can you imagine the yen at 175, a level last seen in 1986, and no official discussion, no economists writing treatises, no journalists wondering about the yellow peril? I cannot.

As documented in the table, the simple reality is that not only has Europe managed a beggar-thy-neighbor (and mind how you pronounce the one with the bowl) devaluation, but the *largest* such devaluation for a major economy, ever! While different time-periods can be chosen to measure the length of a “crisis”, the choice here converges on eighteen months – long enough time for the fire to cool, and also the time taken by the East Asian currencies to begin their recovery path.

From 1985 to now – Euro is devaluation king

The first, and the most famous, bout of currency “volatility” was the Plaza agreement reached between the governments of the majors. In Sept. 1985, a Mercedes-Benz could be bought for less than \$20,000; the US industry was shouting “bloody murder”, and books were being written on “Can America Compete?” The universally accepted answer - it could not, not with \$/DM at 2.7 and \$/yen at 217. The Plaza agreement succeeded, and in eighteen months, the dollar had declined by forty percent with respect to yen and dmark, 14 percent vs. the pound, and somewhat flat against the Canadian dollar. In trade weighted terms (JP Morgan index), real depreciation of the almighty dollar, with much fanfare in the press, and by governments, was 18 percent after eighteen months.

Without much fanfare, and in the guise of market reforms and currency unification, and with the support of institutions like the World Bank and the IMF, China engineered a large 50 percent devaluation during the 1990-1993 period. This real devaluation (Chinese inflation during these years averaged less than 4 percent) was, at least in my opinion (see *Chinese Mercantilism: Currency Wars and How the East was Lost*, ICRIER, July 1998, and downloadable at www.oxusresearch.com), the major cause of the loss of East Asian competitiveness and the onset of the currency crisis in 1997. Over the first eighteen month period, the yuan depreciated in real terms by approximately the same amount as the US dollar five years earlier: 20 percent.

The pound met its Waterloo in Sept. 1992, when it depreciated from close to 3 dmarks to 2.2. After eighteen months, its real decline was only 11 percent. The next big financial crisis was the Mexican devaluation of Dec. 1994; the currency more than doubled with respect to the dollar, but after the cooling of period, the real depreciation was only 20 percent.

Onwards to the world shaking event: East Asian devaluations of 1997-1998. Note that this crisis was huge enough to bring into question the nature of capitalism itself. Many economists at the International Monetary Fund now applaud the totalitarian decision of Mr. Mahathir to impose capital controls. One would conjecture that this crisis must have engineered a very large real depreciation, but eighteen months later, the weighted depreciation was only 20 percent. Note that Indonesia has not been mentioned because it is an outlier, and as argued by me earlier (in the above-mentioned study on Chinese mercantilism), the crisis in Indonesia was political and a boon to pro-democracy forces who helped make the crisis much deeper than the fundamentals deserved – something that Mahathir was smart enough to anticipate for his own country. The next time the liberals applaud Malaysia, they should recognize that they set back democracy/economic freedom by five to ten years.

The home of macro-economic crises, Latin America, was unable to crown itself with a large real devaluation. The Brazilian peso began its descent in Jan. 1999, but by July 2000, the real depreciation was a lowly 7 percent. The second phase of the Brazil devaluation is only six months old and hence not considered.

Onwards to the Euro, the mother of all real devaluations. Actually, the Euro is the mother of mothers, as it depreciated by 26 percent, after eighteen months, and thus the *largest devaluation in history*. The normally agile Western press and the paid to be agile Western investment bankers are still sleeping. While the smart economists have lost fortunes, the Euro central bankers have helped their number one constituency – European industrialists. While the rest of the world is suffering through an industrial recession (all year on year figures for June 2001), the Europeans are not: Japan, -8.7; US -3.2; UK, -2.2; Euro area, plus 1.4; Germany, 1.1; France, 2.3; Portugal, 5.0; Ireland, 13.9 percent.

The Deutsche mark today is at 2.5 vs. the dollar; end-Aug. 1985 (pre-Plaza) it was at 2.67. Mercedes Benz's are again very cheap, but the German car makers are not complaining. The yen then was at 217; today it is at 118 and getting stronger! Mid-eighties saw the advent of Japan bashing in the US. I guess it is a bit difficult for Americans to bash up their ancestors. On a waggish note: with all quiet on the white front, is it plausible that the earlier attack on Japan was racist in nature? In a currency index, Japan has approximately a 14 percent weight, while the Euro has a 58 percent weight. Where is Merc-smashing when we need it ?

We live in a world where the rates of the major currencies are determined in a very large global market. This is true. Thus, it follows that the recent record depreciation of the Euro is nothing to worry about because not much can be done about it. True. The next article will discuss how the savvy European Central Bankers managed the impossible.

The author invites comments on the website www.oxusresearch.com where an archive of articles is also available.

The Progress of Mercantilism - From the Yuan to the Euro

Event	Country	Exchange Rate (vs US\$)		Inflation	Depreciation (%)	
		Start Of Event	18 Months Later		Nominal	Real
Plaza - US \$						
Sep, 1985	USA	.	.	3.5	-30	-18
	Japan	217	145.8	-0.1	40	19
	Germany	2.67	1.81	0	39	13
	Great Britain	0.71	0.62	5.3	14	-9
China - Yuan						
Jan, 1990	China*	4.53	5.88	1.8	-30	-20
ERM Crisis						
Sep, 1992	Great Britain	0.5	0.66	2.3	-29	-11
Tequila Crisis						
Nov, 1994	Mexico	3.44	7.41	55.3	-77	-20
East Asian Crisis						
Jul, 1997	Taiwan	27.8	32.2	1.4	-15	-16
	Singapore	1.43	1.66	-0.3	-15	-6
	Korea	886	1201	5.7	-30	-19
	Malaysia	2.52	3.8	6.6	-41	-34
	Philippines	26.4	39.2	13.2	-40	-30
	Thailand	25.0	36.7	7.0	-47	-17
	East Asia (Wtd Avg)	.	.	6.0	-32	-20
Birth of Euro						
Jan, 1999	Germany	1.67	2.06	2.6	-24	-26
	Euroland*	1.18	0.95	2.7	-24	-26
Brazil						
Dec, 1998	Brazil	1.21	1.82	5.6	-50.4	-7

Source: Eurostat, JP Morgan, IMF and Oxus Research Database

Notes: 1. Depreciation in real terms has been computed as per the JP Morgan Currency Index except for Euroland and China.

2. Real Depreciation for Euroland has been calculated as per the weighted inflation differentials with Europe's major trading partners i.e., U.S., U.K, Japan and Canada.

3. For China, the nominal devaluation represents changes in the official parallel market. The real depreciation is calculated as per IMF figures.